Enron's Professional Intersection
By: Norman B. Arnoff, Esq.

In December 2000 an article was written for this column which addressed the professional liability risks for auditors and the lawyers who are asked to report to auditors on litigation that had a material impact on the financial statements subject to audit[1] In such contexts lawyers, restrained by applicable evidentiary privileges and the client confidentiality obligation, cannot always effectively inform the auditor. Even where the lawyers' reports are both consistent with professional standards and not affected by privilege or confidentiality obligations, the auditor does not generally review with counsel prior to the publication of the financial statements the accounting determinations that have significant legal implications and the footnote disclosures. Audit failure in this context, therefore, can be more effectively prevented when such a pre-release review by the lawyer handling or managing the litigation does take place. Enron's professional intersection, while not identical, is quite similar in that the audit failure resulted from the ineffective coordination and focus of legal and auditing expertise. The accounting treatment of certain transactions and relationships that had significant legal implications and the attendant disclosures were, in the last analysis, ultimately left to the auditor without the benefit of an *independent* legal determination and review. By understanding the material risks of this professional intersection in the audit process, we can here, too, take the right path to reform.

Enron's Historical Antecedents: U.S. v. Simon

In 1969 the United States Court of Appeals for the Second Circuit with Judge Henry Friendly writing the opinion of the Court, in the context of a criminal prosecution of auditors for

their responsibility for a false and misleading financial statement footnote, addressed issues similar to the ones in Enron[2]. The Court noted, almost as a preface to its opinion, "[w]hile every criminal conviction is important to the defendant, there is a special poignancy and a corresponding responsibility on reviewing Judges when, as here, the defendants have been men of blameless lives and respected members of a learned profession."[3] The trial focused on transactions between two affiliated companies that had a single office and were dominated by the same chief executive officer and principal shareholder.

Funds were advanced by one affiliate to the other and as a result the principal-shareholder caused the issue of negotiable notes which were endorsed in blank so that the principal could obtain cash to effect securities transactions for his own account and meet related margin calls. In a five and a half year time span the company whose financial statements were in issue loaned to its affiliate $16 million and in turn the affiliate loaned $13 million to the principal. By the "certification" date the auditors learned the affiliate was not in a position to repay its debt and accordingly, it was arranged that the principal post collateral, eighty (80%) percent of which was the lending company's securities. When cash became stringent and the transactions problematic, corporate counsel listed the securities as collateral and at the auditors request the securities were assigned to counsel as trustee. There were errors in the list furnished by counsel and the auditors also did not check the list by any verification procedures. Third party commercial lenders had prior liens on many of the securities. After the completion of the audit and before the mailing of the financial statements to public shareholders, the securities collateral also significantly declined in market value. Shortly thereafter a check to the IRS "bounced" and bankruptcy ensued.

The core case against the auditors was premised on the fact that the footnote did not disclose the make-up of the collateral and the fact of the post audit market decline. Eight defense expert witnesses, described by the Court as "an impressive array of leaders of the profession" testified that except for the erroneous netting of accounts receivable owed by each company to its affiliate, the footnote treatment of the accountants receivable from the company's affiliate was consistent with both Generally Accepted Auditing Standards ("GAAS") and Generally Accepted Accounting Principles ("GAAP"). Further these experts testified additional disclosures of the collateral's make-up and post-audit decline in market value was not necessary and its absence did not defeat a fair presentation of the company's financial position. Nor did the experts believe the borrowings of the principal from the affiliate to finance his stock transactions had to be disclosed. The Court of Appeals in reviewing the criminal conviction, nonetheless, significantly held literal compliance with GAAS and GAAP did not insulate the auditors from criminal liability. The Court in a message to all professionals in the capital markets and financial services industries that lasts to and through this day, articulated the proposition that professionals are responsible to get to and state the truth, especially when they know or should know the real facts. The Court held:

> " It is quite true that there was no proof of motive in the form usual in fraud cases. None of the defendants made or could make a penny from...putting out false financial statements...Ordinary commercial motivation is thus wholly absent.
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> ...
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> "Even If there were no satisfactory showing of motive, we think the Government produced sufficient evidence of criminal intent. Its burden was not to show that the defendants were wicked men with designs on anyone's purse, which

> they obviously were not, but rather that they had certified a statement knowing it to be false. As... [the Court] said...long ago, 'while there is no allowable inference of knowledge from the mere fact of falsity, there are many cases where from the actors' special situation and continuity of conduct an inference that he did know the untruth of what he said or wrote, may legitimately be drawn"[4]

Thus professional liability risk exists even when there is literal compliance with professional standards.

The Powers Report

A Special Investigative Committee of the Board of Directors of Enron Corporation headed by William C. Powers Jr. rendered a written report February 1, 2002. The report discussed the partnerships that served as Special Purpose Entities ("SPE") which kept liabilities off of Enron's balance sheets, generated significant income for Enron which was subsequently restated, and the conflicting ownership and controlling interests of Enron's CFO and other personnel in the SPE and off- balance sheet partnerships. The respective roles of Enron's internal accountants, Arthur Andersen, Enron's in house counsel, Vinson and Elkins, Enron's outside counsel, and most significantly the related party transaction disclosure issues presented by the footnotes and the proxy statements, are also addressed.

The Powers Report emanated from the Special Committee's mandate to conduct an investigation of related party transactions. The investigation turned up information such as the significant enrichment of Enron's CFO and other employees by reason of their participation in the SPE and non-compliance with Enron's Code of Conduct of Business Affairs, not previously disclosed. Further the report significantly noted that "[m]any of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risks."[5] In reference to these related party

transactions that the legal and audit professionals had to confront the Special Committee also found :

> "Enron's publicly-filed reports disclosed the existence of the...partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, *these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships....* The disclosures also asserted that the related party transactions were reasonable compared to transactions with the third parties, apparently without any factual basis....There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson and Elkins, or at Andersen."[6](Emphasis added)

The Report also noted Andersen's consulting roles and the fees earned from those services included advice on the structuring of the partnerships so that it would meet the SPE non-consolidation rules i.e. essentially the *sine qua non* was an outside investor with a minimum ownership interest of three (3%) percent who had control of the entity. It was also noted "Vinson and Elkins, as Enron's *long standing outside counsel*, provided advice and prepared documentation in connection with many of the transactions...[and] also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements in Enron's periodic SEC filings."(Emphasis added) Further the Report, which discussed corporate governance as well professional responsibility issues noted that "[m]anagement and the Board relied heavily on the perceived approval by Vinson and Elkins of the structure and disclosure of the transactions."[7]

Auditor-Legal Issues

AU Section 336, *Using the Work of a Specialist*, sourced in SAS ("Statement on Auditing Standards") No. 73, makes permissible and appropriate auditor reliance on the work and analysis

of specialists including lawyers. Management or the auditors can engage a specialist and rely on that work as evidential matter in performing substantive tests to evaluate material financial statement assertions. The standard states,

> "[T]he auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation...During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgement require using the work of a specialist to obtain competent evidential matter.
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> ...Examples of the types of matters that may...require...using the work of a specialist include...[i]nterpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property.)"[8]

Where specialists are to be engaged the auditors are to assess their qualifications. Further, they are to evaluate the relationship of the specialist to the client, especially circumstances that might impair the specialists' objectivity. They are to obtain an understanding of the specialist's methods and assumptions, although the appropriateness and reasonableness of the methods and assumptions used and their applications are stated to be the responsibility of the specialist. However, if the auditor believes the specialist's findings are unreasonable additional procedures have to be employed, including obtaining *another* opinion. An unresolved matter should also cause the auditor "to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient competent evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation."[9]

The standard also goes on to state that generally the auditor should not refer to the work or findings of the specialist in that it might be misunderstood to be "a qualification of the auditors' opinion or a division of responsibility neither of which is intended." This is to be

avoided as " ... there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference."

AU Section 9336 provides guidance with respect to Financial Accounting Standards Board ("FASB") Statement No. 125 *Accounting For Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* Utilization of this standard is to assist in interpreting transactions similar to those that occurred between Enron and its off-balance sheet partnerships. The auditor is to give consideration to whether an asset transfer can be revoked, whether a transfer of financial assets would likely be deemed to be a true sale at law, whether the transfer and transferee are affiliated, whether transferred assets are beyond the reach of a bankruptcy trustee, and whether entities truly qualify to be an SPE making remote the possibility that they would enter bankruptcy or receivership. Significantly the section states "*...determinations about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law...[t]his aspect of surrender of control, therefore, is assessed primarily from a legal perspective.*"[10](Emphasis added)

This section also gives some guidance to auditors as to when to rely on the legal opinion furnished or when it is inadequately premised on hypothetical transactions and/or qualified to limit the scope of the opinion so that reliance cannot be placed upon it. The accounting standard, however, is not definitive and carries with it the material risk of the auditor stepping beyond the scope of his expertise and ultimately making a legal judgement.

<u>Considerations For Reform</u>

In the context of the Enron Bankruptcy there is now a temptation to jump to easy criticism of both Arthur Andersen and Vinson and Elkins in respect to the related party transactions addressed by the Powers Report. This is anything but a sound approach. A closer

look at both the facts and the current authoritative accounting literature relating to auditors interacting with lawyers in the audit process demonstrates there are systematic flaws which could lead to other financial disasters with other public companies served by other law and auditing-accounting firms. To avoid future recurrences we should develop insights from the events such as those that occurred in *United States v. Simon* and *Enron* and thereby enhance professional standards for both lawyers and auditors, especially when those professionals are required to coordinate their respective expertise and disciplines in the audit process. In this way we will be able to best serve the securities laws' core-remedial purpose, and follow a correct path to reform.

Points to consider and to discuss are the following: (1) accounting-auditing firms do not have to divest themselves of their consulting arms, but should adhere to a strict rule that the same company should *not* be both an audit and consulting client; (2) fiduciary duty codes should be promulgated for accounting-consultants, which would include reporting obligations to audit committees and the auditors of accounting irregularities and internal control problems discovered and not corrected in their engagements; (3) in respect to public companies meeting certain defined criteria established by the SEC and other self-regulatory organizations, accounting treatments that have to be "assessed from a legal perspective" should be addressed by *independent* counsel--counsel not regularly engaged by the company--that will make the required legal judgement and also do a legal review of the footnote disclosures; and (4) in respect to other public companies whose financial failure may not have such a devastating impact as Enron, the auditor as well as the audit committee should jointly select legal counsel for the legal judgement and review, who may or may not be counsel regularly engaged.

Independent legal counsel will have inquiry power and authority to get to the facts that will support his judgement. Lawyers will have ultimate responsibility to make legal judgments.

In situations where *independent* legal counsel will make the legal judgment and review, auditors also will not be placed in the position of having to shop around for another opinion after having found the first lawyer's opinion to be unreasonable. Nor will the auditor be placed in the position of having to qualify or disclaim where a conflict remains unresolved; the issues will be resolved by independent counsel.

Further the fact of the utilization of this legal judgement and review procedure, including whose legal counsel is and the circumstances of his appointment should be disclosed. Not only will the responsibilities of the company and its professionals be identified, but if the procedures are correctly applied there will be a higher comfort level for the user of the financial statements and a corresponding strength in our capital markets.

Woodrow Wilson wrote "the whole purpose of democracy is to take counsel with one another so as not to depend upon the judgement of any one man but upon the common counsel of all."[11] The points for consideration addressed hopefully will be part of a collective and meaningful discussion leading to the best path for reform of our professional standards so to avoid the material risks of Enron's Professional Intersection.

End Notes

1. N.Y.L.J., Dec. 12, 2000, "Professional Intersection: Lawyers' Responses to Auditors' Letters," by Norman B. Arnoff and Sue C. Jacobs. *See, also* for discussion of issue related to the article, the following: N.Y.L.J., Aug. 8, 2000, "The Fiduciary Responsibility," by Norman B. Arnoff and N.Y.L.J.,k Apr. 25, 2000, "The Fiduciary Duty Standard of Causation," by Norman B. Arnoff and Sue C. Jacobs.

2. *U.S. v. Simon*, 425 F2d 796, 1969, U.S. App. LEXIS 10070, Fed. Sec. L. Rep. (CCH), at 93.

3. *Id.* at 425 F.2d 798-799.

4. *Id.* at 425 F.2d 809.

5. Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., Executive Summary and Conclusions, Summary of Findings, at 4.

6. *Id.*, Public Disclosure at 17.

7. *Id.*, Outside Professional Advisers, at 25-26.

8. Statement on Auditing Standards 73, *Using the Work of the Specialist*, AU Section 336 at 292.

9. *Id.*, AU Section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*, at 295.

10. *Id.*

11. Woodrow Wilson, *The New Freedom.*

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